FISCAL POLICY IN CANADA:
THE CHANGING ROLE OF THE
FEDERAL AND PROVINCIAL GOVERNMENTS

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FISCAL POLICY IN CANADA: THE CHANGING ROLE OF THE FEDERAL AND PROVINCIAL GOVERNMENTS

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FISCAL POLICY IN CANADA: THE CHANGING ROLE OF THE FEDERAL AND PROVINCIAL GOVERNMENTS*

ISSUE DEFINITION

Economic policy is increasingly being conducted by provincial governments. While monetary policy is exclusively in the federal domain, fiscal policy is a shared responsibility. Attention tends to be focused on taxes, spending and deficits at the federal level, but those at the provincial level are in aggregate just as important. In addition, the federal government supplies a significant amount of the financial resources of the provincial governments ($27,100 million in cash transfers in fiscal year 1993, or 14% of total provincial government revenues). In recent budgets, it has attempted to control its own spending by limiting such transfers.

This paper examines some of the prominent trends in provincial and federal fiscal policy since 1975 in order to provide a background against which total fiscal policy and future federal budgets can be evaluated. This is a companion piece to three Current Issue Reviews dealing with federal fiscal policy: CIRs No. 87-2, (*Federal Spending*), 88-7 (*Federal Deficit*), and 90-3 (*Federal Revenues*). The data in this paper came from Statistics Canada's system of government financial management statistics.

BACKGROUND AND ANALYSIS

A. Revenues

Figures 1 and 2 portray recent developments with respect to government revenues. In 1966, provincial revenues were about 80% of their federal counterpart. Provincial revenues

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* The original version of this Current Issue Review was published in January 1991; the paper has been regularly updated since that time.

grew at a much faster pace than federal revenues over the next decade and a half so that the ratio of provincial to federal revenues grew to 1.24:1 in 1979 (see the bar chart in Figure 1). Over the next three years, federal income grew rapidly, dropping the ratio to 1.05:1 in 1982. This ratio since then has fluctuated between 1.08:1 to 1.19:1.

An examination of the major tax categories -- the corporate income tax (CIT), consumption taxes, and the personal income tax (PIT) -- reveals the sources of these overall trends. In all three cases, the provinces have increased their share of tax revenues (see Figure 2). The ratio of provincial to federal CIT receipts increased from 0.3:1 in 1966 to 0.51:1 in 1994. Similarly, the ratio of provincial to federal consumption tax receipts rose from 0.48:1 in 1966 to over 0.96:1 in 1994. The equivalent ratio for the PIT, a much more important tax, increased from 0.32:1 in 1966 to 0.67:1 in 1994. In fact, the provincial share of the PIT increased dramatically from 1975 to 1979, when it reached 75% of the federal share. It declined steadily after that, although the decline has been reversed somewhat since 1988.

The provincial share of consumption taxes is remaining steady, despite the introduction of the Goods and Services Tax (GST) at the federal level.

This dramatic change in relative PIT shares from 1975 to 1979 was intentional. Under the Established Programs Financing Agreements negotiated between the Government of Canada and the provinces, the federal government made tax room available to the provinces. As a result, provincial tax rates rose substantially. These increases were 27% in Manitoba, 28% in Nova Scotia, 38% in Prince Edward Island, 44% in Ontario, and 48% in Alberta.

Through most of the 1980s, the provincial share of the PIT declined. The recent reversal of this trend may be due to provincial government responses to the federal government's income tax reform, which has reduced the reliance on the personal income tax. Several provinces (Prince Edward Island, New Brunswick, Saskatchewan and, most notably, Ontario) have used this opportunity to increase their rates and to add surtaxes as deficit control measures.

Provincial governments have traditionally occupied a large part of the consumption tax field, defined here to include retail sales taxes, motive fuel taxes and other sales taxes at the provincial level, as well as sales and excise taxes at the federal level.

From 1978 to 1984, the provincial share of consumption taxes rose. This was due primarily to a drop in the general Federal Sales Tax (FST) from 12% to 9%, while at the same time a number of provinces increased their retail sales tax rates. For example, from 1976 to 1983, the retail sales tax was increased by two percentage points in each of the Atlantic provinces and by one point in Quebec and Manitoba. After 1984, the federal share of taxes increased as the government returned the general Federal Sales Tax rate to 12% and increased the FST rate on building materials from 5% to 8%.

The introduction of the federal Goods and Services Tax (GST) in 1991 was to increase the federal share of consumption taxes, all other things being equal. There are two major reasons for this. First, the GST is meant to be revenue-neutral with respect to a Federal Sales Tax of 13.5%, not the 12% that existed in the first half of 1989. Second, the GST is to be revenue-neutral in net terms, not gross terms. Since the tax finances an expanded system of refundable tax credits, larger gross revenues should be expected. On balance, though, the impact has been minor due to disappointing GST revenues.

B. Expenditures

1. Total Spending

In aggregate, the federal government spends only slightly more than the provinces. In 1994, the federal government is spending about $176,000 million, while the provinces are spending $173,000 million.

Through the last half of the 1960s and early 1970s, the provincial share of total government spending was increasing steadily. After that time, the trend has levelled off (see Figure 3).

A large part of federal spending is simply transferred to the provinces. By examining what is called "own" spending, defined as total spending less transfers to other levels of government, the picture changes somewhat. The provincial share of "own" spending grew in the last half of the 1960s and early 1970s. After 1972, it declined until 1985. Since then, the ratio has stayed between 8% and 18% above federal spending. These trends are presented in Figure 3a.

2. Program Spending vs. Debt Service Charges

The federal government has implemented a policy of reducing program spending substantially. Figure 3b, which presents a comparison of "own program" spending (defined as total spending less interest costs less transfers to other governments), indicates that this policy has achieved some measure of success. After 1984, the growth in federal own program spending slowed markedly. It shows three distinct trends. In the last half of the 1960s and early 1970s, the provincial share of own program spending rose dramatically. With some temporary reversals, this was maintained until the mid-1980s. After 1985, the growth of federal program spending declined and the provincial share of program spending grew once again.

The real difference between federal and provincial government spending is revealed in debt service charges (see Figure 4). Even though the interest rate faced by provincial governments tends to be higher than that faced by the federal government -- over the past two years provincial long-term bonds have had yields 50 to 90 basis points higher than comparable federal long-term bonds, according to Bank of Canada statistics -- provincial debt service charges are substantially lower. This indicates a much lower stock of debt held by the provincial government sector, the result of smaller past deficits.

From 1966 to 1973, the provincial share of total debt service charges rose dramatically, after which it declined until 1982, when it stood at 0.42:1. The provincial share rose through most of the '80s but subsequently fell sharply from 1988 to 1991. Since 1991, the provincial share has again grown rapidly. Federal debt servicing costs have actually fallen during the past few years due to lower interest rates. The provinces did not benefit from such a decline.

The explanation for this pattern can be found in Figure 5, which looks at annual deficits. In 1966, the federal government ran a surplus. After that year, the relative importance of provincial deficits changed dramatically from year to year. From 1975 to 1982, the ratio of provincial deficits to federal deficits averaged 0.14:1. The federal government was accumulating debt much more rapidly than the provinces, contributing to relatively higher debt servicing costs. From 1983 to 1987, the ratio of provincial deficits to the federal deficit averaged more than 0.27:1. While this was still a low ratio, it was substantially higher than that experienced in the 1970s and

contributed to the rising provincial share of debt service charges. After 1987, however, provincial deficits and the ratio of provincial to federal deficits, fell significantly, contributing to a decline in the provincial share of debt service charges.

From 1989 to 1993, provincial deficits grew faster than their federal counterpart. In 1994, however, provincial deficits are falling, while the federal deficit continues to increase.

In 1989 and 1990, interest rates were very high, especially for financial paper with short terms to maturity. The federal government has for a number of years now been moving to a greater reliance on short-term securities, especially Treasury Bills, since these typically yield less than long-term bonds. The irony of this policy is that it had increased federal borrowing costs because short-term paper had a substantially higher yield than long-term paper in 1989 and 1990. In addition, the use of short-term instruments and high annual deficits meant that the federal government was very susceptible to the increases in interest rates that occurred in 1989 to 1990. Today, however, the use of short-term instruments is saving the federal government substantial amounts of interest costs.

C. Deficits

Like that of the federal government, the fiscal position of the provinces was impaired significantly by the recession of the early 1980s. The deficit of both levels of government ballooned after 1982. But whereas the deficits of provincial governments started to decline immediately after 1983, the federal deficit continued to grow until 1985. And whereas the federal decline has been relatively small, the provincial decline has been more dramatic. The federal deficit in 1990 was 76% of what it was in 1985, when it peaked, and 109% of what it was in 1983, when the recession ended. Total provincial government deficits in 1990 were 40% of the peak level reached in 1987 and 60% of the level reached in 1983.

For the fiscal year ending 31 March 1992, provincial deficits increased substantially, largely due to developments in the province of Ontario. For the first time since 1975 the ratio of provincial to federal deficits exceeded 0.60:1.

In nominal terms, combined provincial deficits exceeded $22,000 million, 2.6 times the amount for fiscal year 1990-1991.

The provincial government sector has in the past been more apt than the federal government to balance its budgets in aggregate. Although the decade of the 1980s has also been characterized by high deficits in the provinces, governments there have been better able than the federal government to restore some sense of fiscal prudence.

The aggregate decline in provincial deficits since 1983 has not been without its reverses. The total of these deficits increased in 1986 and 1987, due mainly to a dramatic increase in the deficits of the four western provinces, which in 1985 had been essentially balancing their budgets, yet by 1987 were running deficits totalling over $6,200 million. The reason for this is clear. Natural resource prices declined substantially in these years and the real value of output fell by 5% in 1986 and did not grow in 1987.

The situation in Ontario was different. From 1983 to 1989, real growth averaged 6.2% per annum, which is exceptionally high by any standard. Yet, not only was the decline in the deficit slow over this period, in 1986 the deficit actually doubled from the previous year. In Quebec the deficit pattern varied only slightly from that of Ontario, even though real growth, at an average of only 4.7% per annum, while very good, was 1.5 percentage points less than in Ontario.

In the last half of the 1970s, when the federal deficit increased substantially, from $1,350 million in 1975 to $11,500 million in 1980, provincial governments' deficits were growing and then declining. Over the entire period, the federal government's cumulative deficit was nine times as high as that of the provinces.

During the latter part of the 1970s, the western provinces ran surpluses consistent with their strong natural resource-based economies. The Atlantic provinces ran steady deficits, small in nominal terms but fairly substantial when compared to the size of their economies. Ontario ran a deficit every year between $1,000 and $2,000 million. The fiscal position of the western provinces appears to be by far the most sensitive to changes in the economic climate.

One reason that the provinces have been so much more able than the federal government to control their deficits in recent years is that they were more able to avoid deficits in

the past. Consequently, they spend on average only $1 of every $6.3 of revenue on interest charges, while federal government spends more than $1 out of every $3 of revenue.

A recent study by the C.D. Howe Institute has criticized the fiscal stance of many provinces, especially the poorer ones which are burdened by very high debt to GDP ratios. The study also criticized provincial governments for failing to use the strong economic performance of the mid to late 1980s to improve their fiscal positions.

D. Federal Transfers to the Provinces

The 1990 and 1991 federal budgets have restricted the amount of cash transfers that the federal government provides to the provinces. In 1990, the federal government announced a two-year freeze on per capita Established Programs Financing transfers to the provinces; the 1991 budget extended this freeze for three years. Canada Assistance Plan payments to non-equalization receiving provinces are to be limited to 5% annual growth for the next five years. These measures will reduce cash transfers by over $5,000 million in five years, even though such federal transfers will continue to grow at rates in excess of the growth of federal program spending.

The provinces can respond to these federal initiatives by reducing spending or increasing taxes. The provinces have already been growing accustomed to a decreasing reliance on federal cash transfers, which accounted for 23% of provincial revenues in 1975 but for only 19% of revenues in 1989. More and more, the provinces have been using their own tax measures to raise revenue. If the alternative to these budgetary measures is continued levels of cash transfers coupled with higher federal taxes, a provincial tax increase is equivalent to a conversion of cash transfers into tax transfers. This is consistent with developments in the past.

As of 1 April 1996, the bulk of federal transfers to the provinces will be in the form of the Canada Health and Social Transfer (CHST), a block grant replacing the CAP and EPF funding but which does not affect equalization. Along with this reform in structure came a reduction in total provincial entitlements and cash transfers.

The 1996 budget has established a five-year funding arrangement that freezes total entitlements for two years at the 1997-98 level of $25,000 million and allows total

entitlements to grow after that at an increasing pace. The 1996 budget also states that a floor for cash transfers will be established at $11,000 million. This is important because the government's ability to enforce the provisions of the *Canada Health Act* and the non-residency requirements for social assistance depend upon a significant federal cash contribution which could be withheld in the event of non compliance by a province.

The 1996 budget also indicates that the federal government has gone some way in addressing the arbitrariness of the original CHST entitlement allocation. Initially, the entitlement for each province was set at about 9.5% less than the previous year's entitlement under CAP and EPF. This led to wide variations in per capita funding. The three non-equalization receiving provinces felt aggrieved because they had been subject previously to the cap on CAP, which had severely restricted severely their access to federal transfers. The federal government is now reforming the allocation to reflect population growth. This reform will reduce by about one-half the initial variation in per capita entitlement.

E. Budgets in 1991

All ten provinces tabled budgets in the spring of 1991. Many of these budgets were consistent with the 1991 federal budget in the sense that they were characterized by restraint in spending and a reluctance to increase income or sales taxes. Despite this restraint in spending, budgetary deficits generally increased, with only a few exceptions.

The most dramatic of the exceptions was found in the Ontario budget. In Ontario, spending was expected to increase by 27% over a two-year period, at the same time as the fiscal position was moving from a $90 million surplus to a $9,726 million deficit.

The Quebec budget predicted a substantial increase in the deficit of that province, although not nearly as dramatic as the increase in Ontario's. In 1992 the Quebec deficit was expected to equal 2.1% of provincial GDP at factor cost, compared to 3.44% in Ontario. The Quebec budget also went against the trend by imposing a substantial increase in sales taxes when its retail sales tax became fully harmonized with the federal GST. At that time, the rate was to be

lowered by one percentage point to compensate for the full taxation of services to be implemented then.

The Nova Scotia budget also contained a unique element. It proposed to increase the provincial personal income tax from 57% to 59.5% of basic federal tax. This 4.4% increase in provincial tax is substantially higher than any increase imposed by other provinces, which have instead usually increased their surtax or corporate tax rates.

F. Budgets in 1992

Provincial budgets for 1992 have generally been characterized by a more fiscally conservative stance than was the case in the previous year. The reported deficit has been reduced in every province except Alberta, although these deficits are still twice as high as they were two years ago, before the effects of the recession were felt.

Ontario's budget contains some controversial items. Part of the deficit reduction is accounted for by a sale of assets, a tactic which would not work under the Public Accounts presentation used by the federal government, and by a claim for additional funds from the federal government and some adjustments to the public service pension scheme. These elements have had the effect of reducing the reported deficit by almost $3,000 million.

Several provinces have increased personal income tax rates in 1992 (B.C., Saskatchewan, Ontario and Newfoundland), while Alberta's rate was reduced. On the business side, there was no uniformity in provincial policies: in some provinces rates were reduced substantially, while in others they were increased.

G. Budgets in 1993

In 1993, all provinces undertook measures to reduce the size of their deficits. On average, these measures will reduce provincial government deficits by an amount close to 1% of Gross Domestic Product. Although there are some significant tax increases, the focus of deficit control appears to be on the spending side.

The personal income tax has been increased in Ontario, Quebec, B.C., Nova Scotia and New Brunswick. These increases are the result of higher tax rates or increased surtaxes. Many provinces have also broadened the base upon which they apply their surtaxes.

New Brunswick and Alberta have both passed into law measures to limit their ability to run deficits, while Ontario has cut about $2,000 million from its payroll by its "social contract" provisions. While the Ontario measures have generated much controversy, other provinces have also reduced public service remuneration.

H. Budgets in 1994

Provincial budgets in 1993 were based on assumptions about aggregate economic growth that proved to be slightly too optimistic. Growth in 1994 is expected to be better, although higher interest rates could dampen growth and somewhat derail deficit projections. Rather higher than expected spending and lower revenues have combined to increase provincial deficits by about 6%.

Most provinces have continued their policies of spending restraint, concentrating on cuts in wages and employment levels in provincial civil service departments. This year's budgets project actual declines in spending in PEI, New Brunswick, Manitoba and Alberta. Social services and health spending tend to be the only areas so far spared major reductions, although Alberta is cutting health expenditures. Many provinces are, however, directing funds to infrastructure in the hope of stimulating employment.

The various provincial budgets in 1994 did not rely upon tax increases to control deficits. Provincial treasurers are expecting tax revenues to grow by 3% in aggregate as a result of enhanced economic activity. Proposed tax changes are generally minor in scope and would reduce taxes for low-income families or small business.

I. 1995 Federal Budget

All the provincial governments have been lamenting the fact that the federal government has curtailed its transfers to them for several years now. This budget proposes to continue that trend. The federal government has not lifted the cap on CAP, nor has it reversed the limits on transfers put in place by previous budgets. Indeed, this budget proposes even further cuts.

At the moment, the equalization program is untouched as it was renewed by Parliament for a five-year period, starting in 1995. As of 1996-97, the Established Programs Financing transfers for post-secondary education and health care and the Canada Assistance Program transfers are to be combined into one block grant, the Canada Health and Social Transfer (CHST). Transfers under the CHST are projected to be $26,900 million in 1996-97 and $25,100 million in 1997-98. This compares with EPF and CAP transfers totalling $29,686 in 1995-96.

In 1996-97, the CHST transfers will be divided amongst the provinces in the same proportion as the combined CAP and EPF is apportioned in 1995-96. After that, a new formula will be a matter of federal-provincial negotiation.

The budget also proposes to restrict transfers under the Fiscal Stabilization Program, so that provinces will be eligible for a transfer payment only if their revenues decline by 5% on a year-over-year basis. The funding formula for transfers to territorial governments is also reduced.

J. Provincial Budgets 1995

Nine provincial governments tabled budgets this year. The former government of Ontario produced a budget plan which was to form the basis of its fiscal policy after the election. The NDP government was, however, defeated by the Progressive Conservatives of Mike Harris, who, in July 1995 offered a fiscal overview and a variety of spending cuts.

The two largest Canadian provinces have the worst fiscal records in the country and appear to be the slowest in dealing with their deficits. In Quebec, the 1995 deficit turned out to be

30% higher than predicted the year before. According to the new Ontario government, the 1995 deficit was substantially under-estimated by the previous government. In both provinces, 1995 deficits are in the neighbourhood of $800 to 900 per capita (see Figure 6). Nova Scotia has the third worst deficit record, at between $200 and $300 per capita, while British Columbia's deficit seems to have stabilized at about $200 per capita.

The remaining six provinces, on the other hand, have all taken serious measures to control their deficits. Newfoundland, New Brunswick and Prince Edward Island are all expecting balanced budgets or surpluses next year, with New Brunswick tightening its budget control legislation. Manitoba is also predicting a surplus next year and has introduced legislation prohibiting deficits and requiring a reduction in outstanding provincial debt. Saskatchewan recorded a surplus in 1995 and is predicting that it will do so again in 1996. Alberta also recorded a surplus. That province's budget uses very cautious revenue forecasts which had led the government to predict a return to deficit in 1996; however, recent reports suggest that 1996 will also be a year of budgetary surplus. The government of Alberta has also strengthened its budgetary control legislation.

These provincial budgets did not, for the most part, take into account the transfer reductions contained in the 1995 federal budget. The Alberta Treasurer has stated that the federal initiatives will not derail the province's fiscal track. The rhetoric of many of the other provincial governments also suggests that they will mostly take these cuts in stride.

K. Total Government Sector

The 1996 federal budget included an assessment of the fiscal position of the total government sector in Canada. It concluded that the fiscal house is in much better order than it was only a few years ago. By 1997-98 the total deficits of all governments will be about 3% of GDP, down from 9.6% in 1992-93. This is due to the fiscal actions of the federal government and the strong fiscal restraint of many provinces. Tougher actions by Ontario and Quebec will speed up this fiscal re-ordering.

Budgets tabled in 1996 and 1995 indicate that deficit reduction is being achieved through program spending cuts rather than tax increases. Both levels of government are now running operating surpluses which are expected to grow as further fiscal restraint is imposed.

PARLIAMENTARY ACTION

Fiscal policy at both levels of government is usually set at budget time and given legislative authority through the Parliament of Canada or the legislatures of the various provinces. The basic framework for federal transfers to the provinces can be found in a number of federal pieces of legislation. These include: the *Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977*; the *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977*, (actually passed in 1983); the *Canada Health Act*; and the *Canada Assistance Plan*.

CHRONOLOGY

1975 - The government of Alberta ran a surplus of $39 million, in addition to the $646 million paid into the recently established Heritage Savings Trust Fund.

\- A new federal-provincial agreement on Established Programs Financing made extensive use of tax transfers. Provincial governments increased their personal income tax rates substantially.

1977 - The Newfoundland budget established the provincial PIT rate at 58% of basic federal tax, a level significantly higher than in any other province.

1981 - The Nova Scotia budget forecast a deficit more than twice as large as the previous year's and equal to 20% of projected revenue.

1982 - The Newfoundland budget set the retail sales tax at 12%, significantly higher than in any other province.

- The Quebec deficit reached $3,000 million for the first time, an amount which was exceeded in every year until 1987.

- The Ontario government extended the base upon which the retail sales tax was applied, resulting in a substantial increase in revenues.

- The budget of the government of Saskatchewan forecast a deficit, the first since 1977.

1987 - The government of Alberta forecast a deficit of $2,100 million, despite the fact that resource revenues were used as budgetary revenues and not placed in the Heritage Fund.

- The Saskatchewan budget noted that the deficit, previously forecast to be $389 million, would in fact be $1,235 million. That budget called for the elimination of 2,000 civil service positions.

1988 - Stage I of tax reform was implemented. It generally lowered tax rates for personal and corporate income, while broadening the base of taxable income. Some provinces used this opportunity to increase their own rates of tax. Prince Edward Island increased its PIT rate to 57% from 55%, and levied a 10% surtax.

- The province of Quebec announced a generous child subsidy plan which would pay as much as $3,000 per child to larger families.

April 1989 - The federal budget limited the growth in per capita Established Programs Financing to the rate of growth of GNP, less three percentage points.

February 1990 - The federal budget contained an expenditure control plan which limited transfers to the provinces. Established Programs Financing payments for fiscal years 1991 and 1992 were limited to their 1990 per capita levels. For the same years, Canada Assistance Program payments to Ontario, Alberta and British Columbia were limited to a 5% annual growth rate.

January 1991 - The Goods and Services Tax was implemented as originally planned. The retail sales tax in the province of Quebec, applying to goods only, was integrated with the GST.

July 1992 - Services were added to the Quebec base.

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FIGURE 1

FEDERAL AND PROVINCIAL FINANCES
GROSS GENERAL REVENUES

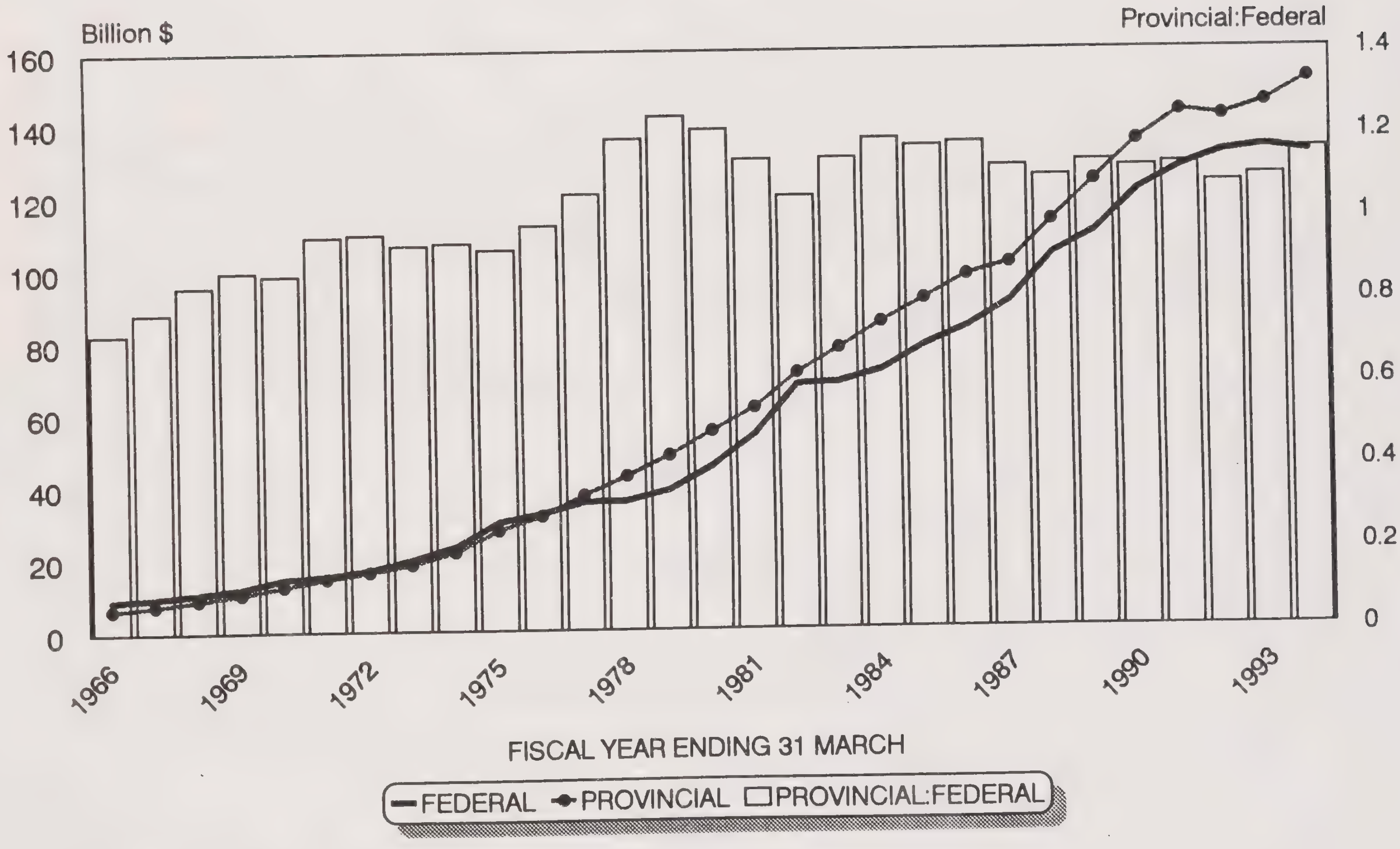

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FIGURE 2

FEDERAL AND PROVINCIAL FINANCES
CONSUMPTION AND INCOME TAXES

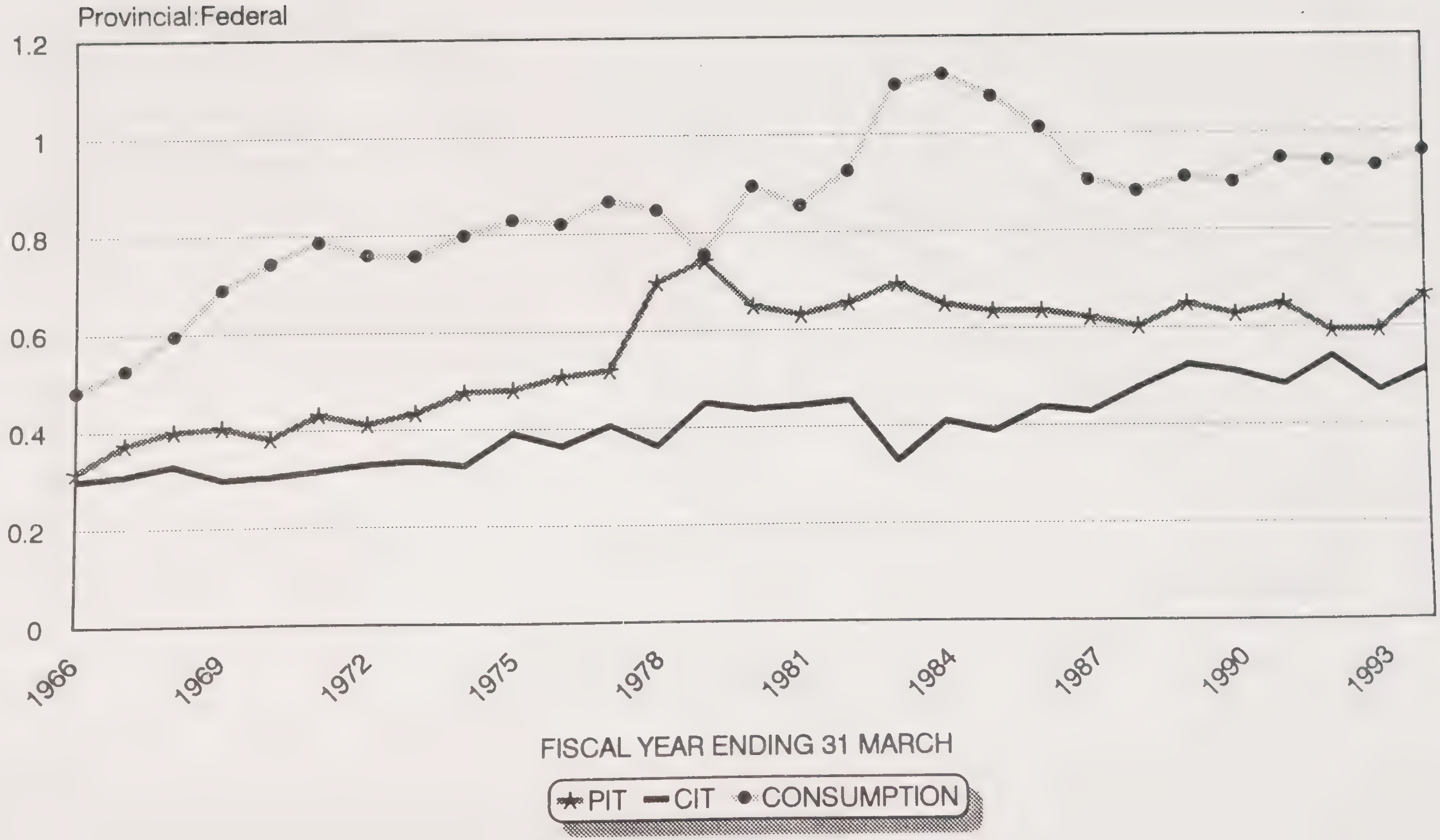

FIGURE 3a

FEDERAL AND PROVINCIAL FINANCES
OWN SPENDING

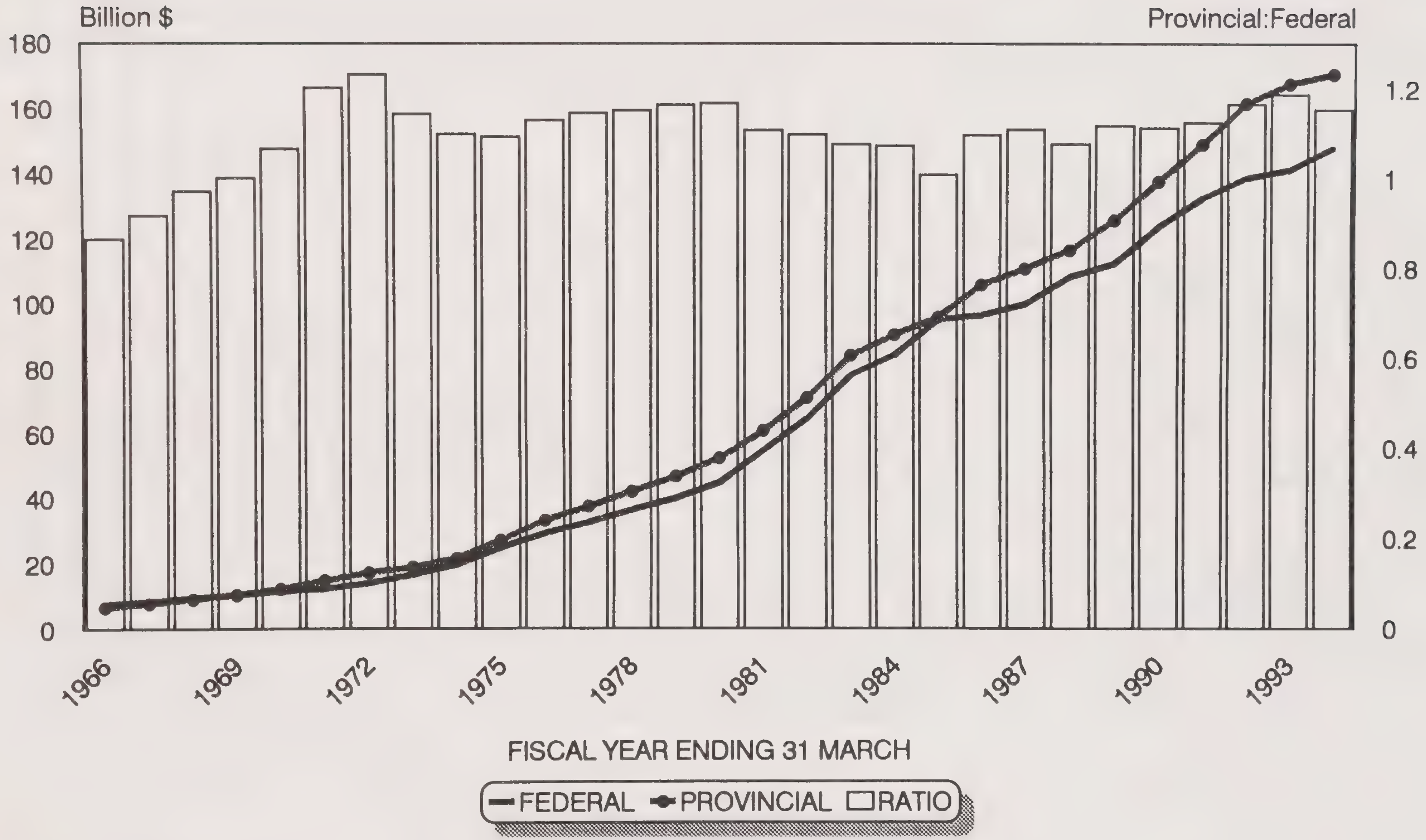

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FIGURE 3b

FEDERAL AND PROVINCIAL FINANCES
OWN PROGRAM SPENDING

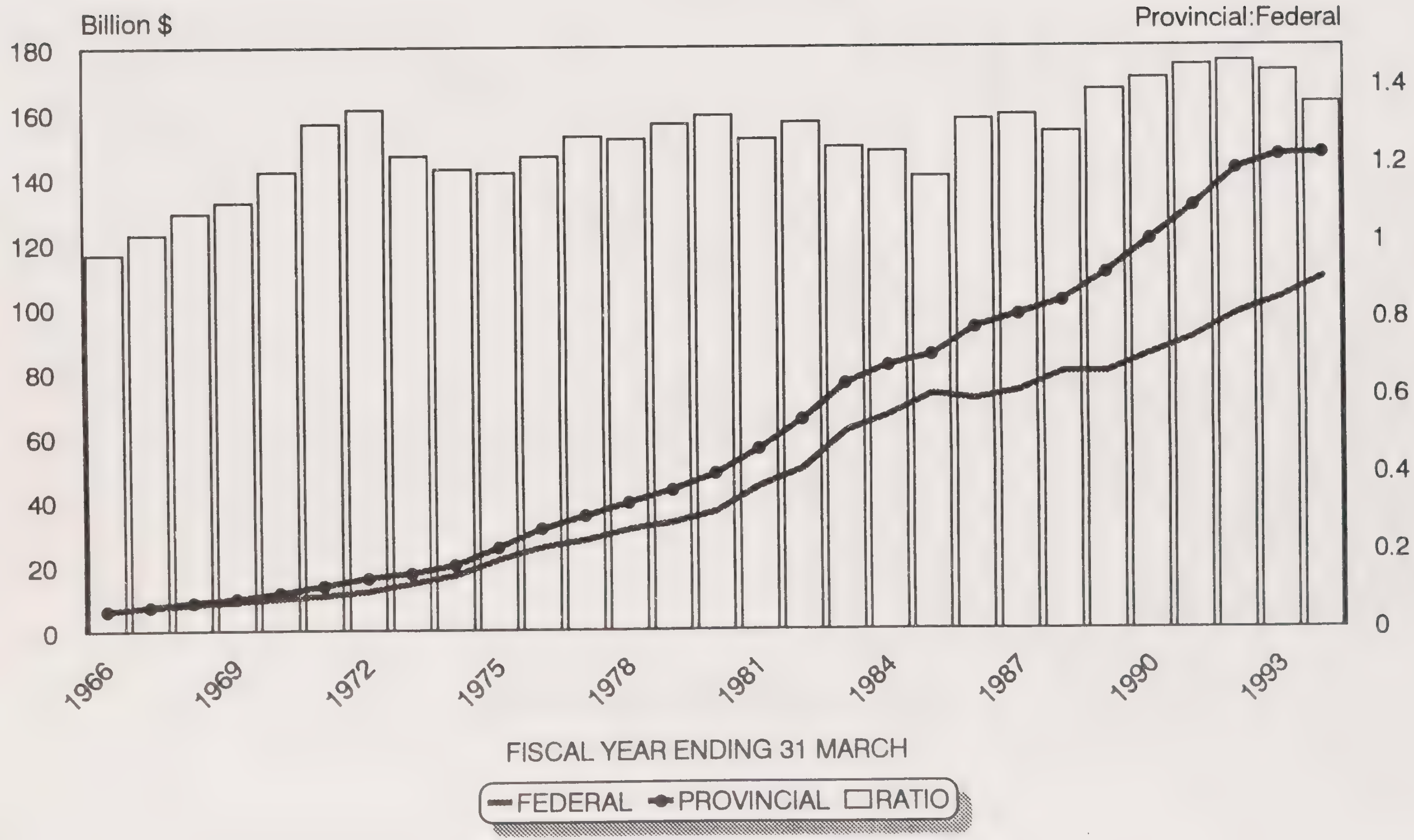

FIGURE 4

FEDERAL AND PROVINCIAL FINANCES
DEBT SERVICE CHARGES

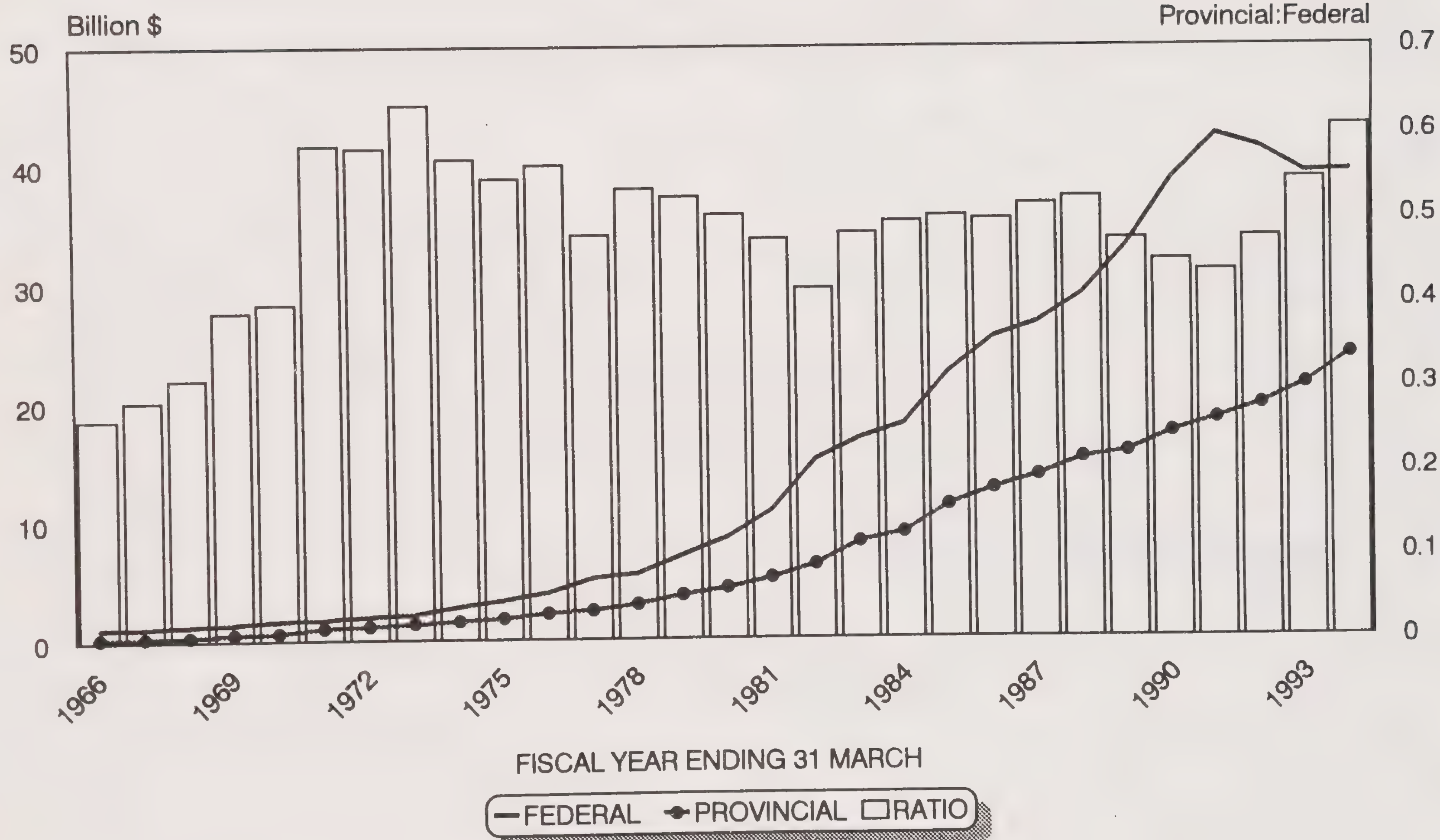

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FIGURE 5

FEDERAL AND PROVINCIAL FINANCES
GOVERNMENT DEFICITS

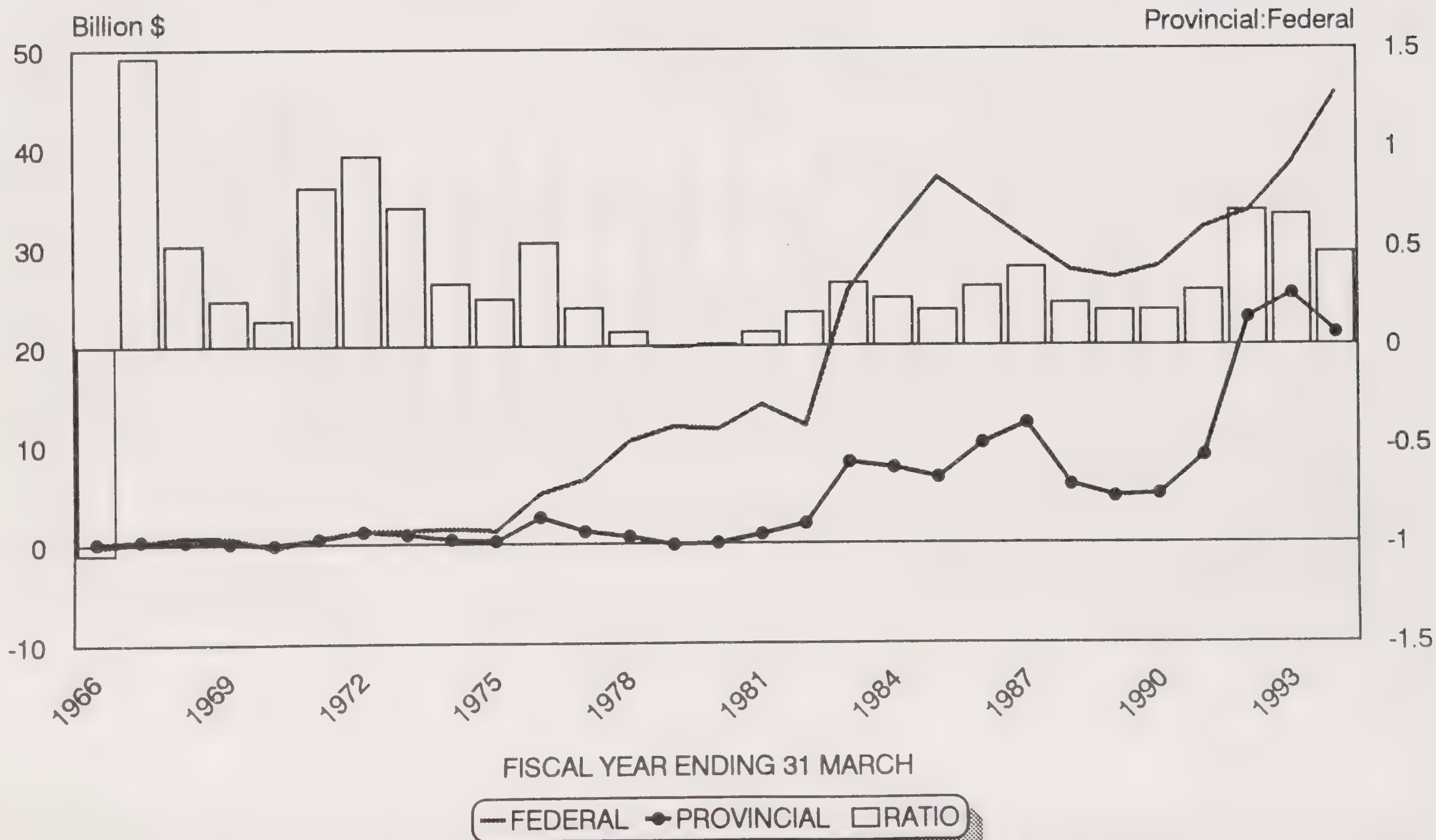
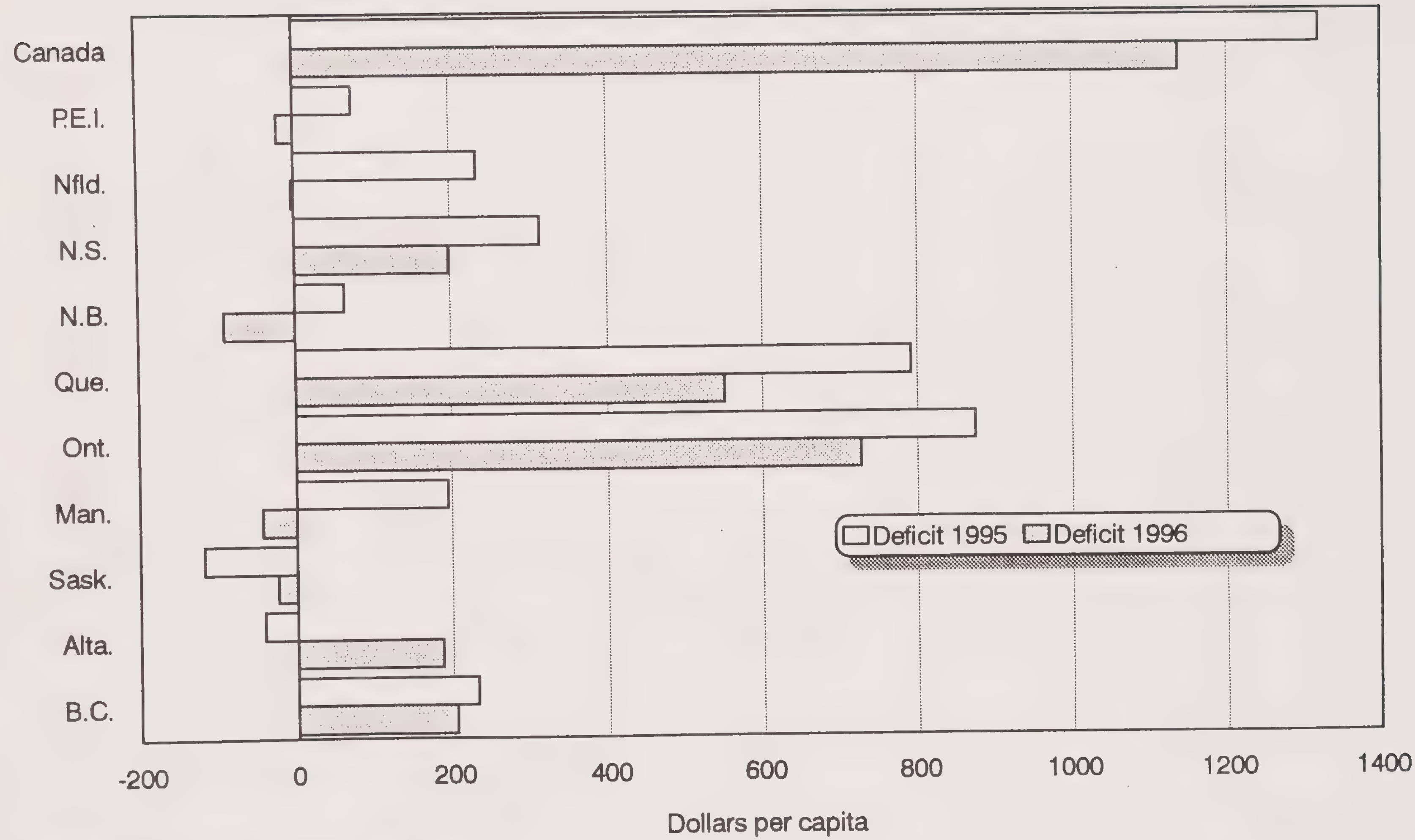


FIGURE 6

PER CAPITA DEFICIT
FISCAL YEARS 1995 AND 1996



A negative amount indicates a budgetary surplus.
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